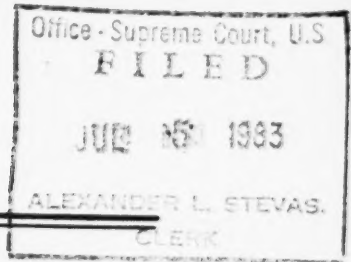


No. 82-1811



In the Supreme Court of the United States

OCTOBER TERM, 1982

DESERT PALACE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE NINTH CIRCUIT*

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
*Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217*

TABLE OF AUTHORITIES

	Page
Cases:	
<i>Automobile Club v. Commissioner</i> , 353 U.S. 180	8
<i>Automobile Insurance Co. v. Commissioner</i> , 72 F.2d 265	7
<i>Barker v. Magruder</i> , 95 F.2d 122	6
<i>Barker v. United States</i> , 26 F. Supp. 1004	6
<i>Brown v. Helvering</i> , 291 U.S. 193	9
<i>Commissioner v. Hansen</i> , 360 U.S. 446	9
<i>Commissioner v. Segall</i> , 114 F.2d 706, cert. denied, 313 U.S. 562	7
<i>Continental Tie & Lumber Co. v. United States</i> , 286 U.S. 290	5
<i>Dixon v. United States</i> , 381 U.S. 68	8
<i>Eastman Kodak Co. v. United States</i> , 534 F.2d 252	7
<i>Flamingo Resort, Inc. v. United States</i> , 485 F. Supp. 926	3, 7-8, 9
<i>Flamingo Resort, Inc. v. United States</i> , 664 F.2d 1387, cert. denied, <i>sub nom. Hilton Hotels Corp. v. United States</i> , No. 82-404 (Nov. 29, 1982)	3, 4, 9
<i>Nightingale v. United States</i> , 684 F.2d 611	9
<i>Schlude v. Commissioner</i> , 372 U.S. 128	5, 9
<i>Spring City Foundry Co. v. Commissioner</i> , 292 U.S. 182	5

II

Page

Cases—Continued:

<i>Thor Power Tool Co. v. Commissioner</i> , 439 U.S. 522	9
<i>Travis v. Commissioner</i> , 406 F.2d 987	5, 7
<i>United States v. Anderson</i> , 269 U.S. 422	4
<i>United States v. Byrum</i> , 408 U.S. 125	6

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)):

Section 165	4, 9
Section 166	4, 10

Transportation Act of 1920, ch. 91, Section 204, 41 Stat. 460	5
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Treasury Regulations on Income Tax (1954 Code) (25 C.F.R.):

Section 1.451-1(a)	6
Section 1.461-1(a)(2)	6

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner seeks review of the decision below that it was required to accrue into its income, for federal income tax purposes, accounts receivable generated by its extension of credit to patrons of its licensed Nevada gambling casino, even though the receivables were not enforceable under Nevada law because they were gambling debts.

The relevant facts were stipulated, and may be summarized as follows: Petitioner operated a licensed gambling casino in Las Vegas, Nevada (Pet. App. 2a-3a). As a regular part of the casino's business, petitioner permitted some of its customers to gamble on credit (*id.* at 4a-7a). A line of credit was granted only after the casino conducted an extensive credit check on the customer, including an inquiry of a Las Vegas information clearing service as to whether the customer had a history of paying, or refusing to pay, gambling debts (*id.* at 6a-7a). The customer executed an IOU in

the form of a counter-check to evidence the credit advanced (*id.* at 5a n.4). These IOU's represented between 22% and 30% of petitioner's receipts from gambling (*id.* at 4a). The IOU's that were not redeemed by the close of play were deposited for presentation through the banking system for payment by the customer's bank (*id.* at 5a n.4, 11a-12a). Some IOU's that remained outstanding were sent for collection to an attorney or to a collection agency where the customer resided (*id.* at 12a-13a). The courts of Nevada and of other states do not enforce a gambling debt if a debtor raises the defense, and establishes that the debt was incurred for gambling purposes (*id.* at 10a-11a, 18a). The evidence showed that few, if any, of petitioner's customers raised that defense. As a result, petitioner was able to collect almost 95% of the IOU's (*id.* at 10^a-13a).

Petitioner kept its books and prepared its federal income tax returns on the accrual basis of accounting. It did not, however, accrue into its income for tax purposes the accounts receivable that it set up on its books to reflect the IOU's outstanding (Pet. App. 12a-13a).¹ Instead, it reported the receivables as income only for the years in which the IOU's were paid (*ibid.*). On audit, the Commissioner determined that the receivables should be accrued into petitioner's income for the years in which they arose (*id.* at 17a). He accordingly determined deficiencies totalling \$6,573,146.83 in petitioner's income tax for its tax years ending in 1967, 1968, and 1969 (*id.* at 1a).

Petitioner thereafter brought this suit in the Tax Court for redetermination of the Commissioner's deficiencies. The parties stipulated that if the receivables were held to be accruable, petitioner would be entitled to deductions in

¹In contrast, on petitioner's financial statements the receivables were accrued as income, net of a provision for doubtful accounts (Pet. App. 15a).

specified amounts for the years in question for losses or for bad debts (Pet. App. 1a-2a). As a result of a concession by the Commissioner,² the Tax Court ruled that to the extent a customer's IOU to the casino would be treated by state courts as a gambling debt, and therefore unenforceable, the IOU did not represent accruable income until paid (*id.* at 20a-21a).

The court of appeals reversed (Pet. App. 22a-23a). It pointed out that petitioner conceded that this case was on all fours with *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387 (9th Cir. 1982), cert. denied, No. 82-404 (Nov. 29, 1982), where the court had required accrual of such casino receivables at the time the credit was extended. There, the court found from the circumstances surrounding the creation and repayment of the receivables that they were in practical effect as fixed and determinable as possible and, in fact, no less fixed than the obligations incurred by customers of other businesses; that the amounts owed could be determined with reasonable accuracy; and that there was at

²The Commissioner initially took the position in the Tax Court that the receivables were not gambling debts and that their treatment therefore was not affected by restrictions on the judicial enforcement of gambling debts (Pet. App. 18a-20a). In a supplemental brief, he stated that to the extent the receivables were gambling debts, the absence of legal enforceability would preclude them from being sufficiently fixed and definite to require their accrual into petitioner's income (*ibid.*). Before the Tax Court entered its decision, the Commissioner concluded that this concession was in error, and sought reconsideration of the Tax Court's opinion, in light of *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926 (D. Nev. 1980). There, the district court held that the receivables of another duly licensed Las Vegas casino that extended credit to its patrons in the course of its gambling business were accruable into income. The Tax Court, however, denied the Commissioner's motion for reconsideration. Thereafter, the Ninth Circuit affirmed the decision in *Flamingo Resort* (664 F.2d 1387 (1982)), and this Court denied certiorari *sub nom. Hilton Hotels Corp. v. United States*, No. 82-404 (Nov. 29, 1982).

least a reasonable expectation of collection (Pet. App. 35a). The *Flamingo Resort* court saw no reason to permit a casino owner lawfully engaged in gambling to defer recognition of its income because of potential legal objections to payment available to its debtors that did not interfere with its business and were seldom, if ever, raised (*id.* at 34a-35a). The court below adhered to its prior *Flamingo Resort* decision and concluded that it controlled this case (*id.* at 22a-23a).³

1. The decision below correctly held that petitioner was required to accrue into income the receivables generated by its extension of credit to patrons of its casino, less an appropriate allowance for losses or for bad debts. In so ruling, the court below adhered to its prior decision in *Flamingo Resort*. That decision is fully consistent with the decisions of this Court and of other courts that have required, in certain circumstances, the accrual of a right to income, or of a liability for an expense, even though the right was not legally enforceable. There is, accordingly, no more reason to grant certiorari here than there was in *Flamingo Resort*, in which this Court denied certiorari earlier this Term.

In *United States v. Anderson*, 269 U.S. 422 (1926), from which the "all events" test for the accrual of income and deductions derives, the Court held that a tax on profits from the sale of munitions was accruable (and hence deductible) by a taxpayer in the year in which the munitions were sold, and not the following year when the tax was assessed and first became a legally enforceable liability of the taxpayer.

³Petitioner's suggestion that *Flamingo Resort* should be reconsidered was rejected by the panel and by all active judges of the court of appeals (Pet. App. 22a-23a). The court also rejected petitioner's contention that *Flamingo Resort* should not be applied retroactively. It therefore remanded the case for a determination whether the stipulated deductions for uncollectible accounts to which petitioner was entitled should be treated as losses under Section 165 of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. V)), or as bad debts under Section 166 (Pet. App. 22a-23a).

As the Court explained (269 U.S. at 441): "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."

In *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290 (1932), the Court reached the same result with respect to the accrual of income. There, income was paid to a taxpayer in 1923 as an award pursuant to Section 204 of the Transportation Act of 1920, ch. 91, 41 Stat. 460. Although the Court agreed with the taxpayer that in 1920 "no proceeding was available to compel an allowance [of the award], or to determine the elements which should enter into the calculation," it nevertheless held that the taxpayer's right to the award accrued when the Act became law in 1920. As the Court stated (286 U.S. at 295): "The right to the award was fixed by the passage of the Transportation Act." The Court thus rejected the taxpayer's argument that the lack of legal enforceability of a claim precluded its accrual for purposes of the "all events" test.⁴ See also *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184-185 (1934).

⁴A similar argument was presented by the taxpayers in *Schlude v. Commissioner*, 372 U.S. 128 (1963). There, the taxpayers contended that accrual was not required of amounts due and payable under the terms of an executory contract where the state law barred a suit for the enforcement of such amounts prior to the rendition of services. (*Schlude v. Commissioner*, *supra*, Petitioner's Br. 1962 Term, No. 80, at 16-18.) Without discussion of that contention, the Court ruled that accrual of that income was proper. It explained (372 U.S. at 137; emphasis in original; citation omitted): "For an accrual basis taxpayer 'it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income,' and here the right to receive these installments had become fixed at least at the time they were due and payable." See *Travis v. Commissioner*, 406 F.2d 987, 989 (6th Cir. 1969), where the same argument against accrual of unenforceable sums due under the terms of an executory contract was expressly rejected.

In accord with these decisions, the Treasury Regulations provide that for an accrual basis taxpayer such as petitioner, "income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treasury Regulations on Income Tax (1954 Code), Section 1.451-1(a) (26 C.F.R.); see Section 1.461-1(a)(2).

The decisions of the courts of appeals and the Court of Claims refute petitioner's contention (Pet. 6-11) that legal liability must always exist before accrual of an item of income or expense is proper. Legal enforceability is but one of the circumstances that bears on whether an income or expense is sufficiently fixed and ascertainable to be accrued. The decision below is therefore not in conflict with any decision or with the Treasury Regulations. None of the cases cited by petitioner (*ibid.*) holds that a right to income cannot be accrued unless it is legally enforceable.⁵ Like this case, *Barker v. Magruder*, 95 F.2d 122 (D.C. Cir. 1938), involved a lender whose right to income was subject to a legal defense—in that case, the defense was that the rate of interest called for under the terms of a loan was violative of the anti-usury statute then in force in the District of Columbia. The court held that the interest nonetheless was accruable based on all the facts and circumstances. It stated "[t]he correct answer, as we think, depends not so much, as appellants urge, upon the legal right to enforce collection as upon the existing probability of its being received" (95 F.2d at 123). The Court of Claims reached an identical conclusion with respect to the accrual of usurious interest in *Barker v. United States*, 26 F. Supp. 1004 (1939).

⁵Petitioner's reliance (Pet. 8) on *United States v. Byrum*, 408 U.S. 125, 136-137 (1972), is misplaced. This Court's statement there that the phrase "right * * * to designate" a beneficiary of property connotes a legally enforceable power was made with reference to whether a power over property retained by a decedent rendered the property includible in his estate under the estate tax. It has no bearing on whether petitioner's right to receivables was accruable in its income under the income tax.

Similarly, in *Automobile Insurance Co. v. Commissioner*, 72 F.2d 265, 268 (2d Cir. 1934), the court upheld accrualability of wartime damages payable by the Mixed Claims Commission even though the taxpayer did not have, and might never have, any means to enforce collection of the award. And as we have noted (see note 4, *supra*), in *Travis v. Commissioner*, 406 F.2d 987 (6th Cir. 1969), the court held that the taxpayer was required to accrue amounts due to it on an executory installment contract even though under state law the right to receive the installments was not legally enforceable because they were for services that had yet to be rendered. The court observed that the course of dealing of the parties to the contract as well as the terms of the contract indicated that the parties regarded the taxpayer's right to receive payment to be binding. It therefore concluded that accrual of the payments was required despite the lack of legal enforceability when " 'the transaction * * * [was] viewed as a whole and in the light of realism and practicality' " (406 F.2d at 990, quoting *Commissioner v. Segall*, 114 F.2d 706, 709 (6th Cir. 1940), cert. denied, 313 U.S. 562 (1941)). See also *Eastman Kodak Co. v. United States*, 534 F.2d 252, 257 (Ct. Cl. 1976) ("The 'all events' test * * * looks to a liability that is so fixed that the fact of liability is certain and the amount thereof reasonably ascertainable, *although not necessarily legally enforceable*" (emphasis supplied)).

2. The court below correctly applied the appropriate tests for accrual to the facts of this case. All the events had occurred to fix petitioner's right to receive payment of its receivables when its patrons' gambling losses were reflected by the IOU's they executed. Only the actual receipt of the income, not the right to receive it, remained at all contingent. As the district court pointed out in *Flamingo Resort*, the right to income evidenced by such IOU's was for a sum certain, payable on demand or within less than 30 days (see 485 F. Supp. at 938).

Here, as in *Flamingo Resort*, the IOU's took the form of counter-checks, which indicated to the customer that their execution resulted in a binding obligation. They were collectible through normal banking channels unless the customer issued a stop payment order. The fact that the casino made use of these credit extensions as a regular, if not essential, part of its business, and that they were preceded by a detailed credit check on the customer, supported the existence of a reasonable expectancy of payment. Indeed, despite the limitations on judicial enforcement, petitioner's collection rate on its IOU's was close to 95% (Pet. App. 11a). It is therefore highly doubtful that legal enforceability of the IOU's would or could increase the rate of collection (see Pet. App. 34a-35a). In these circumstances, the court of appeals was amply justified in concluding that an absence of legal enforceability did not bar accrual of the receivables. Indeed, petitioner's argument that the "all events" test is not satisfied until actual payment occurs is tantamount to seeking cash basis treatment for its gambling winnings attributable to its extension of credit to customers even though it is an accrual basis taxpayer. It would in effect place casino owners on a hybrid system of accounting under which they would enjoy the dual benefits of deferring recognition of a part of their receipts while continuing to accrue all their expenses.⁶

⁶As the court of appeals correctly recognized (Pet. App. 36a n.5), the Commissioner's concession (see page 3 note 2, *supra*) was not of controlling significance. At the outset of the case, he conceded that a lack of legal enforceability would prevent the accrual of certain of petitioner's receivables. But the Commissioner retracted this concession before the Tax Court entered its decision. Petitioner does not claim that its conduct of this suit was prejudiced by the Commissioner's change in position. At all events, as this Court has made clear on several occasions, the Commissioner is free to make such a change when he determines that his initial position is in error. See *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *Dixon v. United States*, 381 U.S. 68 (1965).

3. Finally, there is no basis for petitioner's contention (Pet. 11-15) that the decision below sanctions (to the jeopardy of the revenue) the deduction of expenses, or the creation of deductible reserves for expenses, based solely on a probability that the expenses will be incurred. Estimated liabilities that are contingent upon future events generally are not accruable for tax purposes even though they may be highly predictable in the aggregate. See *Brown v. Helvering*, 291 U.S. 193 (1934); *Nightingale v. United States*, 684 F.2d 611, 614-615 (9th Cir. 1982); cf. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979). Nothing in the decision below departs from that principle.

Contrary to petitioner's argument (Pet. 6, 13), the decision did not require petitioner to accrue its IOU's into income simply because of a probability that they would be paid. Nor was petitioner's right to payment (as distinguished from the actual receipt of payment) contingent upon any event. See *Schlude v. Commissioner*, 372 U.S. 128, 137 (1963); *Commissioner v. Hansen*, 360 U.S. 446, 464 (1959). Instead, the court based its decision in this case on all of the facts and circumstances pertinent to petitioner's experience with respect to its gambling receivables that showed petitioner's right to payment to be fixed, unconditional, and binding (Pet. App. 34a-35a). Thus, in its prior *Flamingo Resorts* decision, the court took care to make explicit that it regarded legal enforceability as relevant to whether a right to income is "fixed" for purposes of accrual accounting. It held only that an absence of legal enforceability did not preclude the Commissioner from requiring the accrual of income under the circumstances obtaining in that case (*id.* at 36a). Accordingly, the court of appeals in this case properly adhered to the rule it previously established in *Flamingo Resorts*.⁷

⁷In the instant case, the court of appeals instructed the Tax Court to determine on remand whether the stipulated deductions to which petitioner is entitled should be allowed under Section 165 of the 1954 Code

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

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as losses or under Section 166 of the 1954 Code as bad debts (Pet. App. 23a). It therefore remains to be determined whether, as petitioner argues now (Pet. 10-11 n.4), the Treasury Regulations under Section 166 deny it a bad debt deduction or a bad debt reserve for its uncollectible receivables. At all events, if it accrues its receivables into income for the years involved in this suit, it is assured of partially offsetting deductions for the same years under the one provision or the other.